

A cool down, but not a double dip

Leading indicators are suggesting that the forecast in our *2010 Investment Outlook* - that global recovery would start to slow in the second half of this year and 2011 growth would be weaker than 2010 – is happening. Markets have reacted with fears of a ‘double-dip’ back into recession, but in our view the indicators merely confirm the growth slowdown we predicted at the start of the year, as the recovery runs into the stiff headwinds of consumer deleveraging, weak employment growth and fiscal consolidation. So far, coincident indicators suggest the risk of a return to recession remains low.

Room for further disappointment

While recession fears helped fuel the recent sell-off in risk assets, consensus GDP forecasts have not yet been scaled back to appropriate levels, leaving room for further disappointment as economic data weakens into 2011.

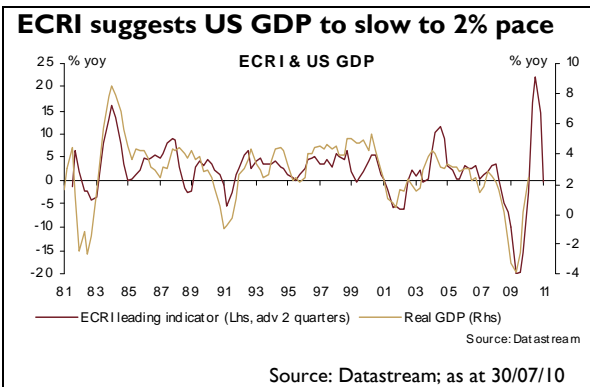
Compared to the consensus, we estimate a US and euro-zone slowdown will subtract 0.5 of a percentage point (pp) directly from world growth, and 0.3 pp indirectly (e.g. via a decline in trade). Thus we expect global growth to be 2.5% next year, versus the 3.3% consensus. At 2.5%, this would only be slightly below the 2.7% long-term average.

The Conference Board’s (CB) leading indicator, historically the best fit among indicators for forecasting US recessions, is currently suggesting only a 6% probability in the next 6 months. However, the recent significant decline in the Economic Cycle Research Institute’s (ECRI) leading indicator suggests a 30% probability. Our own model, based on spare capacity in the economy, unemployment and the ISM survey, points to a 10% probability that the US experiences a double dip in the next six months and only 2% probability in the next quarter.

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The probability of a slow-growth period, which we define as two quarters of GDP growth of less than 2%, is only 10% according to the CB indicator, but a much higher 51% according to the ECRI. The ECRI, which has been a good predictor of US GDP two quarters hence, is currently suggesting that annualised growth will slow to 2% by year end.



As the US and euro-zone slow, emerging Asia will suffer a decline in export demand. However, with much healthier government balance sheets and inflation in check, these countries have more scope to provide domestic monetary and fiscal stimulus to offset weaker exports.

A sustained period of sub-par growth, with inflation risks clearly on the downside, will keep interest rates low for longer. Government bond yields will remain under downward pressure, driving yield hungry investors into higher-yielding assets like corporate bonds, commercial property and dividend-paying equities, pushing up their value.

Equities are unlikely to power ahead until the economic recovery is far more mature. Nevertheless, even our below-consensus 2011 growth forecast is still consistent with positive returns from equities in the next 12 months.

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